Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Frommer	Analyst:	Jeff Garnier	Bill Number:	AB 1601
Related Bills:	See Legislative History	Telephone:	845-5322	Amended Date:	7/3, 7/16, 8/18, 9/2, 9/8/03
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Tax Shelters & Tax Avoidance/Increase in Penalties Imposed/FTB Develop & Administer Voluntary Compliance Initiative

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ________________________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ________________________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ________________________ STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY

This bill would:

- Create a regime of penalties and reporting requirements for investors, promoters, tax advisors, and tax preparers involved in abusive tax shelters to identify existing abusive tax shelter transactions on tax returns filed in prior years and to curtail the use of abusive tax shelters in future years.
- Provide for a voluntary compliance initiative permitting a taxpayer to file an amended return and pay the tax and interest associated with the abusive tax shelter and avoid the imposition of certain new penalties.
- Extend the statute of limitations for taxpayers involved in abusive tax shelters from four to eight years.
- Expand the department's ability to issue subpoenas to taxpayers involved in abusive tax shelters.
- Expand the rules to enjoin abusive tax shelter promoters from marketing shelters within this state.
- Impose interest on deficiencies mailed to taxpayers with taxable income greater than $200,000 that are involved in an abusive tax shelter.

Board Position:			Department Director	Date
______ S	______ NA	______ NP	Gerald H. Goldberg	9/15/03
______ SA	______ O	______ NAR		
______ N	______ OUA	__X__ PENDING		

SUMMARY OF AMENDMENTS

The July 3, 2003, amendments change the existing penalties in the bill and several other penalties to match the penalty provisions relating to abusive tax shelters contained in U.S. Senator Grassley's CARE Act of 2003 (S. 476, the Senator's bill has not been enacted into law). The July 3, 2003, amendments also added the codification of the economic substance doctrine.

The July 16, 2003, amendments made all the penalties in the bill apply only to taxpayers involved in abusive tax shelters.

The August 18, 2003, amendments added the voluntary compliance initiative, expanded the subpoena and injunction rules, and permitted the imposition of interest on taxpayers with taxable income greater than $200,000 that are involved in an abusive tax shelter.

The September 2, 2003, amendments removed the codification of the economic substance doctrine provision and changed the disclosure requirements for promoters and/or material advisors. The amendments also made numerous technical corrections.

The September 8, 2003, amendments limit the Franchise Tax Board's ability to designate a California only tax shelter or listed transaction to shelters or transactions entered into on or after September 2, 2003. It is the intent of the Legislature that no penalty would be imposed for California only transactions entered into before September 2, 2003. It is also the Legislature's intent that the new reporting requirements apply to any transaction entered into on or after February 28, 2000, that becomes a "listed transaction" for federal income tax purposes at any time.

PURPOSE OF THE BILL

The authors' staff indicate that the purpose of this bill is to curtail the use of abusive tax shelters and restore fairness to the tax system. Specifically, this bill modifies existing statutes and enhances penalties to mitigate the attractiveness of these shelters to tax preparers, promoters, and participants. Finally, the bill provides a chance for participants to avoid the enhanced penalties this bill would create, if the participants pay all tax and interest underpaid from using these transactions.

EFFECTIVE/OPERATIVE DATE

Unless otherwise provided, this bill would be effective and operative January 1, 2004. This bill would only become operative if SB 614 of the 2003-04 regular session is chaptered.

POSITION

Pending.

ANALYSIS

Tax Shelter Background

Although there is no precise definition of an abusive tax shelter, an abusive tax shelter involves a transaction or a series of transactions that on the surface appear to meet the letter of the tax law. The transactions themselves lack any economic substance and consequently are shams. The economic substance doctrine (ESD) is a judicially created doctrine and today is elementary to examining the validity of a tax scheme. In lay terms, the ESD states that a transaction, after being stripped of its tax benefits, must have more than a de minimus amount of economic value to the parties. This does not mean that tax benefits must be totally absent from the value of the transaction; however, tax benefits cannot be the principal reason for entering into a transaction.

Most abusive shelters use numerous “step transactions” to arrive at the desired tax result. Taxpayers use pass-through entities and spread the step transactions over multiple tax years to complicate the issue and impede identification. Today’s shelters have become so sophisticated that a highly trained individual is required just to identify the shelter, much less to examine the shelter. A flowchart diagramming a basic abusive tax shelter is attached as **Appendix I**.

THIS BILL

Among other tax shelter curtailment provisions, this bill enhances the reporting requirements for tax shelters, increases existing penalties, and creates new penalties to curtail abusive tax shelters. All new or expanded penalties affected by this bill only apply to taxpayers involved in abusive tax shelters. A complete explanation of current federal and state laws affected by this bill and the provisions of this bill are attached as **Appendix II**.[1] A summary of the topics of this bill and corresponding Appendix II page number are:

1. **Penalty For Failure To Disclose Reportable Transactions (Page 2).** Creates a $15,000 penalty for failing to disclose a reportable transaction. The penalty amount is increased to $30,000 if the failure is with respect to a listed transaction. The penalty only applies if the taxpayer is a large entity or a high net worth individual. Current federal law requires the disclosure of reportable transactions (this bill would conform to the federal provision). Federal law does not have a specific penalty for failing to disclose a reportable transaction. However, such a failure to disclose may jeopardize a taxpayer's defense against the accuracy related penalty and their ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause and that the taxpayer acted in good faith. It is the intent of the Legislature that no penalty would be imposed for California only transactions entered into before September 2, 2003.

   “Reportable transactions” are transactions that have the potential of being an abusive tax shelter. The reportable transaction must meet one of six categories of predetermined thresholds (e.g., transactions generating $250,000 of tax credits if the taxpayer holds the underlying asset for less than 45 days or the transaction is offered under any type of “stop loss” agreement). Most reportable transactions (as are most “tax shelters”) are legitimate business/tax transactions.

[1] Some of the information for Appendix II was derived from the federal Senate Finance Committee Report on the Care Act of 2003 (S. 476).

The first category of reportable transactions is "listed transactions" or transactions substantially similar to listed transactions. Listed transactions are transactions specifically identified by the Internal Revenue Service (IRS) as being abusive. Details of the particular scheme and why it is abusive is provided in IRS notices, bulletins or other sources and posted on the IRS' website.

2. **Modifications To The Accuracy-Related Penalties For Listed Transactions And Reportable Transactions Having A Significant Tax Avoidance Purpose (Page 5).** Modifies the present-law accuracy related penalty (ARP) by replacing the rules applicable to tax shelters with new ARP rules that apply to listed transactions and reportable transactions with a significant tax avoidance purpose. One modification is that a taxpayer cannot rely on opinions from tax advisors if the tax advisor is a material advisor (as defined under IRC 6112/R&TC 18648) or receives compensation from a material advisor.

3. **Penalty For Understatements From Transactions Lacking Economic Substance (Page 9).** Creates a penalty for an understatement attributable to any transaction that lacks economic substance or business purpose (the two terms are closely related). The penalty may also be assessed if an entity is disregarded because it lacks economic substance. The penalty rate is 40% and is reduced to 20% if the taxpayer adequately disclosed the relevant facts on the tax return.

4. **Modifications To The Substantial Understatement Penalty (Page 11).** Modifies the definition of "substantial" for corporate taxpayers. This bill would elevate the standard that a corporate taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item the facts of which are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. For corporations, the bill also changes the threshold of substantial understatement of tax from the <u>greater</u> of $5,000 or 10% of the tax required to be shown on the return to the <u>lesser</u> of $5 million or 10% of the tax required to be shown on the return.

5. **Tax Shelter Exception To Confidentiality Privileges Relating To Taxpayer Communications (Page 12).** Modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision contained in the Revenue & Taxation Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

6. **Modification to the Registration Of A Tax Shelter And Penalty For Failure To Register Requirements (Page 12).** Fully conforms to the federal tax shelter registration requirements with California modifications. Modifications include California requiring additional information if the Franchise Tax Board (FTB) publishes the additional request in a public notice prior to the date the shelter or transaction was entered into. The bill also provides a clear set of triggers for registration of tax shelters organized outside of the state. Abusive tax shelters, that entered into before the effective date of this bill (January 1, 2004) and that become a listed transaction at any time must be registered by April 30, 2004, or 60 days after the shelter becomes a listed transaction. The bill specifies that transactions that become California only listed transactions are not required to register if the transaction was entered into before September 2, 2003.

Creates a penalty on any material advisor that fails to file an information return. The amount of the penalty is $15,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $100,000 or (2) 50% of the gross income of such person with respect to aid, assistance, or advice provided before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a reportable transaction increases the penalty to 75% of the gross income.

7. **Investor Lists And Modification Of Penalty For Failure To Maintain Investor Lists (Page 15).** Creates a penalty for failure to maintain and furnish the required list. A material advisor who is required to maintain an investor list and who fails to make the list available upon request by the Franchise Tax Board within 20 business days after the request will be subject to a $10,000 per day penalty. Rules similar to the tax shelter registration requirements becoming a listed transaction apply and would require a material advisor to automatically provide the list to the FTB when a transaction becomes listed.

8. **Actions To Enjoin Conduct With Respect To Tax Shelters And Reportable Transactions (Page 17).** Expands the rules for obtaining tax shelter injunctions to include the requirements to report transactions and keep a list of investors by material advisors.

9. **Understatement Of Taxpayer's Liability By Income Tax Return Preparer (Page 17).** Alters the standards of conduct that must be met to avoid an increased penalty. Replaces the “realistic possibility” standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. In addition, replaces the “not frivolous” standard with the requirement that there be a reasonable basis for the tax treatment of the position. The penalty for not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from $250 to $1,000. The penalty for willful or reckless conduct is increased from $1,000 to $5,000.

10. **Penalty On Frivolous Tax Returns And Submissions (Page 18).** Increases the frivolous return penalty amount to a maximum of $5,000 and also applies the penalty to all taxpayers.

11. **Penalties On Promoters Of Tax Shelters (Page 19).** Increases the penalty amount to 50% of the gross income derived by the person from the activity for which the penalty is imposed.

12. **Extend Statute Of Limitations For Abusive Tax Shelter Transactions (Page 19).** Extends the statute of limitations from four years to eight years for taxpayers that invest in an abusive tax shelter transaction.

13. **Expansion Of The Franchise Tax Board’s Authority To Issue Subpoenas (Page 20).** Expands authority to issue subpoenas from one of the three members of the Franchise Tax Board to include the Executive Officer of the Franchise Tax Board or any designee.

14. **Modification Of The Suspension Of The Accrual Of Interest Provision (Page 21).** Provides that the suspension of interest provision does not apply to taxpayers with taxable income greater than $200,000.

15. **Increase In Interest Rate And Interest Based Penalty for Reportable Transactions (Page 21).** Creates a penalty equal to 100% of the accrued interest for a potentially abusive tax shelter. Increases the interest rate by 50% for amended returns filed after April 15, 2004.

16. **Voluntary Compliance Initiative (Page 22).** Establishes a one-time voluntary compliance initiative (VCI) allowing taxpayers to file amended returns and pay the tax and interest to avoid all current penalties and additional penalties proposed under this bill. The VCI period is January 1, 2004, through April 15, 2004.

The following table depicts how participation in the VCI benefits a taxpayer:

Taxpayer Action	20% ARP	75% Civil Fraud Penalty	20-40% Non Economic Substance Penalty	100% Interest Penalty	50% Increase in Interest
Taxpayer has not been notified by FTB or IRS, files amended return before 12/31/03	NA	NA	NA	NA	NA
Taxpayer has been notified, files amended return or audit completed before 12/31/03	S	S	NA	NA*	NA
Taxpayer notified or not, files amended return between January 1, and April 15, 2004 under the VCI:					
Option A	NA	NA	NA	NA	NA
Option B	S	NA	NA	NA	NA
Taxpayer has not been notified, files amended return after April 15, 2004	NA	NA	S	NA	A
Taxpayer has been notified, files amended return after April 15, 2004	S	S	S	A	A

The term "amended return" means a qualified amended return under Treasury Regulations and may eliminate or reduce the ARP and non-economic substance penalties. Assumes all amended returns filed during the VCI period qualify for the VCI.

Legend: ARP = Accuracy Related Penalty
NA = Not Applicable
S = Subject To
A = Applies

*Footnote: Penalty applies if amended return filed after the date of enactment

IMPLEMENTATION CONSIDERATIONS

This bill would require the department to promote the VCI and audit amended returns filed under option B of the VCI. As a mandated workload, additional personnel would be required.

LEGISLATIVE HISTORY

SB 614 (Cedillo & Burton, 2003) is identical to this bill. SB 614 is currently on the Assembly Floor.

PROGRAM BACKGROUND

The U.S. Senate passed Senator's Grassley's CARE Act of 2003 (S. 476) 95-5 in March 2003. The CARE Act contains tax shelter provisions similar to the provisions contained in this bill including: extending the statue of limitations (SOL), codifying the ESD, and increasing and creating penalties for tax shelter investors, preparers, and promoters. This bill is fashioned after the CARE Act's tax shelter provisions. The CARE Act was enacted into federal law in June without the tax shelter curtailment provisions. H.R. 2896 (Thomas) was introduced into the House of Representatives on July 25, 2003. H.R. 2896 contains many of the same provisions that were contained in S. 476 and are contained in this bill.

OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws.

Based on a limited review, none of these states have an extended SOL or specific penalties for abusive tax shelter transactions. In addition, it appears these states have not agreed to accept an amended return filed under the federal offshore voluntary compliance initiative.

The review included the individual states' websites, tax forms, and tax handbooks.

FISCAL IMPACT

The department estimates that promoting and administering the VCI, auditing amended VCI returns, and sustaining denials of claims will require 11 personnel years at a one-time cost of $1 million. In addition, two personnel years will be needed for programming and processing changes for a one-time cost of $200,000.

ECONOMIC IMPACT

Revenue Estimate

Based on the data and assumptions below, order of magnitude revenue effects are estimated as follows:

Estimated Revenue Impact Years Beginning On or After January 1, 2004 Enactment Assumed After June 30, 2003 Fiscal Years (In Millions)			
	2003-04	2004-05	2005-06
Abusive Tax Avoidance Transactions	+$90	+$90	+$50

Revenue Discussion

This proposal would create a VCI and increase or create new penalties effective on or after January 1, 2004, on any return for which the statute of limitations on assessment is still open and would otherwise apply on or after January 1, 2004. The revenue associated with the 2003-04 year is derived from the VCI enacted by this bill. The majority of the revenue associated with the 2004-05 and 2005-06 years is projected to result from increased self-compliance.

This estimate is based on federal estimates for similar proposed legislation, federal experience with voluntary compliance programs of this type, and department information.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Additional Revenue Discussion

The department estimates as much as ½ billion dollars in tax revenue has been lost by the State of California in each of the past four years due to abusive tax shelters. In addition to the anti-tax shelter provisions contained in this bill, an estimate of an additional 33 personnel years will be needed to recoup all or most of the $2 billion tax shelter revenue losses. These positions will add to the deterrent effect of this bill for future years. These 33 personnel years will cost approximately $3.7 million annually for the next three years and are not directly associated with this bill.

LEGAL IMPACT

This bill extends the SOL to issue proposed assessments for tax returns already filed where the current SOL is open. The bill also expands or creates civil penalties for past actions. Case law[2] provides that the prohibition against ex post facto laws applies only to penal legislation that imposes or increases *criminal* punishment for conduct predating its enactment. This bill would create only civil penalties. Consequently, the provisions of this bill that would expand civil penalties or extend the SOL are not prohibited under provisions of the U.S. and California Constitutions that prohibit ex post facto laws.

POLICY CONCERNS

Individuals and corporations are increasingly using sophisticated transactions to avoid or evade income tax. Such a phenomenon could pose a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system. Many taxpayers are engaging in tax avoidance transactions that rely on the interaction of highly technical tax law provisions. These transactions usually produce surprising results that were not contemplated by lawmakers. The present-law definition of substantial understatement allows large corporate taxpayers to avoid the ARP on questionable transactions of a significant size.

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[2] *Bankers' Trust Co. v. Blodgett*, 260 U.S. 647, 67 L. Ed. 439, 43 S. Ct. 233 (1923); *Karpa v. Commissioner* (4th Cir. 1990) 909 F.2d 784; *Harisiades v. Shaughnessy*, 342 U.S. 580, 594, 96 L. Ed. 586, 72 S. Ct. 512 (1952); *Johannessen v. United States*, 225 U.S. 227, 242, 56 L. Ed. 1066, 32 S. Ct. 613 (1912).

The current promoter registration rules have not proven particularly helpful because the rules are not appropriate for the kinds of abusive transactions now prevalent, and the limitations regarding confidential corporate arrangements have proven easy to circumvent. Additionally, the present law promoter requirement of maintaining customer lists is not meaningful. Requiring material advisors to maintain a list of advisees with respect to each reportable transaction, coupled with more meaningful penalties for failing to maintain an investor list, are important tools in the ongoing efforts to curb the use of abusive tax avoidance transactions.

It is believed that some taxpayers will continue to engage in tax avoidance transactions until the risks and costs of engaging in the transactions are significantly increased.

This bill emphasizes combating abusive tax avoidance transactions by requiring increased disclosure of such transactions by all parties involved. Taxpayers would be subject to a strict liability penalty on an understatement of tax that is attributable to non-disclosed listed transactions or non-disclosed reportable transactions that have a significant purpose of tax avoidance. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, a more meaningful (but less stringent) ARP would apply to such transactions even when disclosed.

The bill provides a single, clear definition regarding the types of transactions that taxpayers and material advisors must disclose, coupled with more meaningful penalties for failing to disclose such transactions. Both are necessary tools if the effort to curb the use of abusive tax avoidance transactions is to be effective.

The standards of conduct applicable to income tax return preparers should be the same as the standards applicable to taxpayers. Accordingly, this bill requires the minimum standard for each undisclosed position on a tax return would be that the preparer must reasonably believe that the tax treatment is more likely than not the proper tax treatment. This standard is appropriate because the tax return is signed under penalties of perjury, which implies a high standard of diligence in determining the facts and substantial accuracy in determining and applying the rules that govern those facts. It is both appropriate and vital to the tax system that both taxpayers and their return preparers file tax returns that they reasonably believe are more likely than not correct. In addition, conforming the standards of conduct applicable to income tax return preparers to the standards applicable to taxpayers will simplify the law by reducing confusion inherent in different standards applying to the same behavior.

LEGISLATIVE STAFF CONTACT

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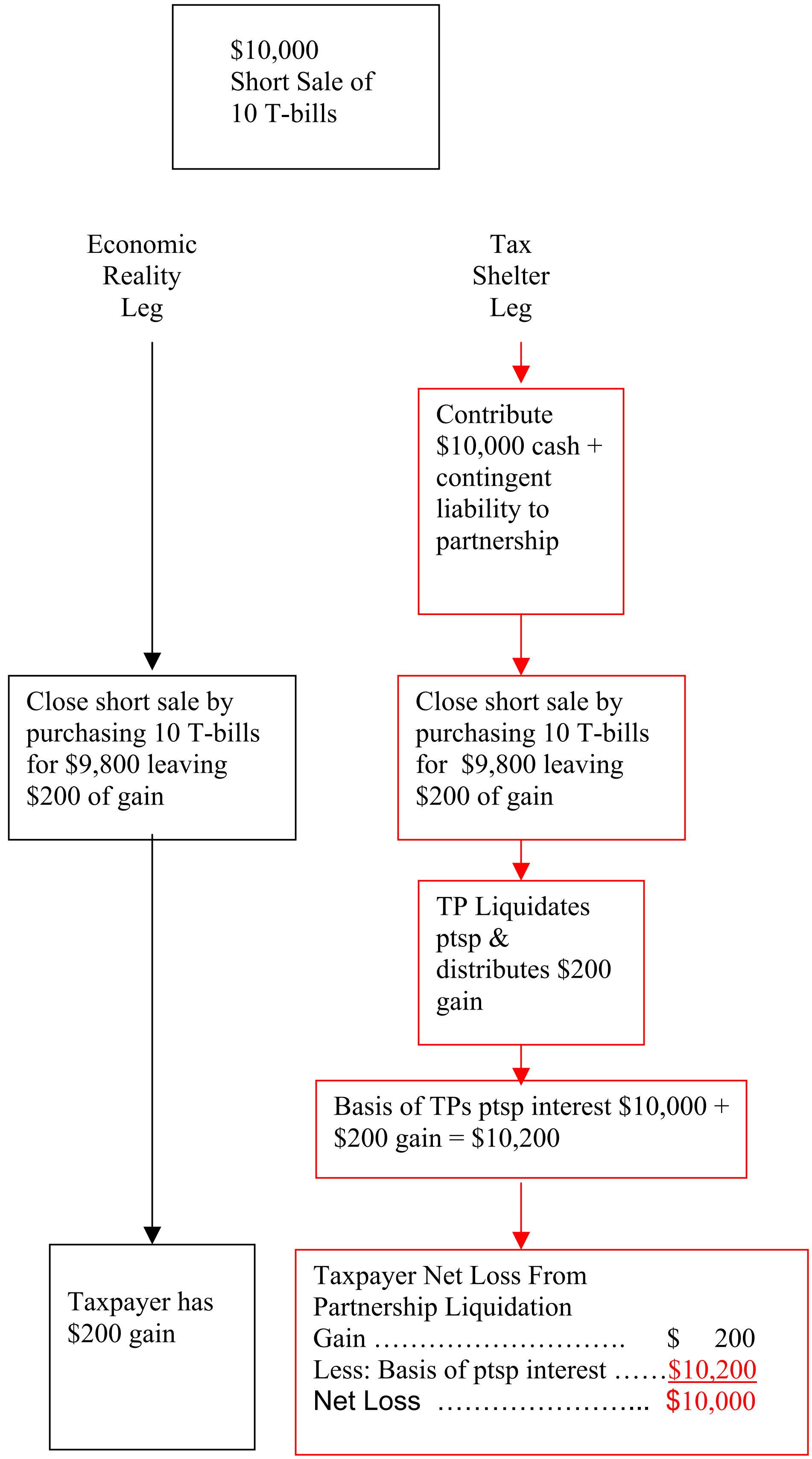
Appendix I
Inflated Partnership Basis Shelter

Using a stockbroker, TP obligates himself to sell ten $1000 T-Bills worth $10,000 today on the open market to be delivered in 14 days. Buyer pays broker $10,000 which broker deposits in TP's account with an unknown liability equal to the value of the ten T-bills in 14 days.

TP contributes the $10,000 and contingent liability to a partnership. TP's basis in the partnership is $10,000.

TP liquidates the partnership after holding the partnership interest for the full 14 days and closes the short transaction.

If on day 14, the FMV of ten $1000 T Bills is only $9800, the TP will recognize a $200 gain. All but $200 of the $10,000 was used to purchase the ten T Bills. The FMV of the partnership is now $200. TP's basis in the partnership interest is $10,200 ($10,000 original + $200 gain). Upon liquidation the TP will recognize a $10,000 loss ($200 cash



1. PENALTY FOR FAILURE TO DISCLOSE REPORTABLE TRANSACTIONS

FEDERAL LAW

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction"). The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Also, the term must be broadly construed in favor of disclosure.

The second category is any transaction that is offered under conditions of confidentiality. If a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).

The third category of reportable transaction is any transaction for which the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained. Such protection can include recission rights, the right to a refund of fees, contingent fees, insurance protection with respect to the tax treatment, or a tax indemnity or similar agreement.

The fourth category of reportable transactions relates to any transaction resulting in, or that is reasonably expected to result in, a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer; (2) $5 million in any single year or $10 million in any combination of years by a partnership or S corporation; (3) $2 million in any single year or $4 million in any combination of years by an individual or trust; or (4) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.

The fifth category of reportable transactions refers to any transaction done by certain taxpayers in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year. The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have $100 million or more in gross assets. The regulations exempt 13 types of transactions from the book-tax reportable transaction category.

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith. Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664 (REG-126016-01) that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

CALIFORNIA LAW

Presently, California law does not conform to these provisions of IRC Section 6011, and therefore, does not conform to the section's underlying regulations requiring taxpayers to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates. California law does require a taxpayer who received a tax "shelter" registration number under federal or state law to include that information on the taxpayer's income tax return.

THIS BILL

In general

This bill would conform to IRC Section 6011, and therefore, conform to the section's underlying regulations requiring taxpayers to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.

Additionally, this bill creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

This bill defines the terms "reportable transaction" to mean any transaction, as determined under regulations prescribed by the Secretary of the Treasury or by the Franchise Tax Board that transaction is of a type that the Secretary of the Treasury or the Franchise Tax Board determines as having a potential for tax avoidance or evasion including deductions, basis, credits, entity classification, dividend elimination, or omission of income and shall be reported on the return or statement required to be made. As discussed above, there are six reportable transactions.

The term "listed transaction" means a reportable transaction that is the same as, or substantially similar to, a transaction specifically identified by the Secretary of the Treasury or by the Franchise Tax Board as a tax avoidance transaction including deductions, basis, credits, entity classification, dividend elimination, or omission of income and shall be reported on the return or statement required to be made. The Franchise Tax Board must publish "listed transactions," whether identified by the Internal Revenue Service or the Franchise Tax Board, on the Franchise Tax Board website, and in Franchise Tax Board notices or other published positions.

"Substantially similar" is defined in the Treasury Regulations to mean any transaction that is expected to obtain the same or similar tax benefits and is either factually similar or based on the same or similar tax strategy. Opinions concluding that the tax benefits from the transaction are allowable are not relevant to the determination that a transaction is substantially similar to a listed transaction. The term "substantially similar" is to be broadly construed in favor of disclosure.

Presently the Internal Revenue Service has identified 25 "listed transactions":

1. Notice 2003-24 - Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds under § 419A(f)(5)
2. Notice 2003-22 - Offshore Deferred Compensation Arrangements
3. Revenue Ruling 2003-6 - Abuses Associated with S Corp ESOPs
4. Notice 2002-70– Certain Reinsurance Arrangements
5. Notice 2002-65– Passthrough Entity Straddle Tax Shelter
6. Notice 2002-50– Partnership Straddle Tax Shelter
7. Revenue Ruling 2002-46– §401k Accelerators
   Revenue Ruling 2002-73 - modifies RR 2002-46 for taxpayers electing to change method of accounting.
8. Notice 2002-35 – Notional Principal Contracts
   Revenue Ruling 2002-30 - Notional Principal Contracts
9. Notice 2002-21 – Inflated Basis "CARDS" Transactions
10. Notice 2001- 45 – §302 Basis-Shifting Transactions
11. Notice 2001-17 - §351 Contingent Liability
12. Notice 2001-16 – Intermediary Transactions
    Coordinated Issue Paper - Intermediary Transactions
13. Notice 2000-61 – Guam Trust
14. Notice 2000-60 – Stock Compensation Transactions
15. Notice 2000-44 – Inflated Partnership Basis Transactions
16. Revenue Ruling 2000-12 – Debt Straddles
17. Treasury Regulation § 1.7701(l)-3 – Fast Pay or Step-Down Preferred Transactions
18. Notice 99-59 – BOSS Transactions
19. Revenue Ruling 99-14 – Lease-In / Lease-Out or LILO Transactions
20. Treasury Regulation § 1.643(a)-8 – Certain Distributions from Charitable Remainder Trusts
21. ASA Investering Partnership v. Commissioner -Transactions similar to that described in the ASA Investering litigation and in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998)

22. Notice 98-5, part II – Foreign Tax Credit Transactions
23. Notice 95-53 – Lease Strips
24. Notice 95-34 – Certain Trusts Purported to be Multiple Employer Welfare Funds Exempted from the Lists of §§ 419 and 419A
25. Revenue Ruling 90-105 – Certain Accelerated Deductions for Contributions to a Qualified Cash or Deferred Arrangement or Matching Contributions to a Defined Contribution Plan

These categories of listed transactions are described in greater detail on the Internal Revenue Service's website at www.irs.gov.

Penalty rate

The penalty for failing to disclose a reportable transaction is $15,000. The amount is increased to $30,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $30,000 for a reportable transaction and $60,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the California income tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Chief Counsel of the Franchise Tax Board and cannot be delegated. The taxpayer cannot appeal a refusal to rescind a penalty.

A "large entity" is defined as any entity with gross receipts in excess of $10 million in the year of the transaction or in the preceding year. A "high net worth individual" is defined as any individual whose net worth exceeds $2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

It is the intent of the Legislature that no penalty be imposed for California only transactions entered into prior to September 2, 2003.

2. MODIFICATIONS TO THE ACCURACY-RELATED PENALTIES FOR LISTED TRANSACTIONS AND REPORTABLE TRANSACTIONS HAVING A SIGNIFICANT TAX AVOIDANCE PURPOSE

FEDERAL LAW

The accuracy-related penalty (ARP) applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10% of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20% of the underpayment of tax attributable to the understatement. The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. Special rules apply with respect to tax shelters. For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith. The relevant Treasury Regulations provide that reasonable cause exists where the taxpayer:

> reasonably relies in "good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.

<u>CALIFORNIA LAW</u>

California law fully conforms to the federal ARP.

<u>THIS BILL</u>

In general

This bill modifies the present-law ARP by replacing the rules applicable to tax shelters with a new ARP that applies to reportable transactions and listed transactions[3] with a significant tax avoidance purpose (hereinafter referred to as a reportable avoidance transaction). The penalty rate and defenses available to avoid the penalty vary depending on the category of the transaction (i.e., listed or reportable avoidance transaction) and whether the transaction was adequately disclosed.

Disclosed transactions

In general, a 20% ARP is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30% of the understatement. The authority to rescind the 30% penalty can only be exercised by the Chief Counsel of the Franchise Tax Board and cannot be delegated. The taxpayer cannot appeal a refusal to rescind a penalty.

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[3] The terms "reportable transaction" and "listed transaction" have the same meanings as previously described in connection with the penalty for failing to disclose reportable transactions.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this bill, the amount of the understatement is determined as the sum of --

> (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return). For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income, and
>
> (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

A taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after when the taxpayer is first contacted regarding the potential abusive tax shelter transaction.

Strengthened reasonable cause exception

A penalty is not imposed under this bill with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires:

> (1) adequate disclosure (as previous discussed) of the facts affecting the transaction in accordance with the regulations under section 6011,
> (2) there is or was substantial authority for such treatment, and
> (3) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief:
>> (a) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and
>> (b) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that:
>>> (1) a return will not be audited,
>>> (2) the treatment will not be raised on audit, or
>>> (3) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a “disqualified tax advisor,” or (2) is a “disqualified opinion.”

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[4] and who participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated directly or indirectly[5] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary of the Treasury or the Franchise Tax Board, has a continuing financial interest with respect to the transaction.

Organization, management, promotion, or sale of a transaction

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body. Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction.

Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion, or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary of the Treasury or the Franchise Tax Board, has a continuing financial interest with respect to the transaction).

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, finding, or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary of the Treasury or the Franchise Tax Board.

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[4] The term "material advisor" (defined below in connection with the new information filing requirements for material advisors under new R&TC Section 19775) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

[5] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

Coordination with other penalties

Any understatement to which a penalty is imposed under this bill is not subject to the ARP discussed above. However, such understatement is included for purposes of determining whether any understatement is a substantial understatement as defined the ARP.

The penalty imposed under this provision shall not apply to any portion of an understatement to which a fraud penalty is applied.

3. PENALTY FOR UNDERSTATEMENTS FROM TRANSACTIONS LACKING ECONOMIC SUBSTANCE

FEDERAL LAW

As stated above, an ARP applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10% of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20% of the underpayment of tax attributable to the understatement. The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters

For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith. The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.

CALIFORNIA LAW

California law fully conforms to the ARP.

THIS BILL

This bill would impose a penalty for an understatement attributable to any transaction that lacks economic substance (hereinafter a “non-economic substance transaction understatement”). Thus, unlike the new accuracy-related penalty discussed above (which applies only to listed and reportable avoidance transactions), the new penalty under this provision applies to any transaction that lacks economic substance. The penalty rate is 40%. The penalty is reduced to 20% if the taxpayer adequately disclosed the relevant facts on his or her tax return. For purposes of this penalty, adequately disclosed includes a taxpayer reporting the tax shelter identification number (a present law requirement) on his or her return. No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the bill (i.e., the penalty is a strict-liability penalty).

A “non-economic substance transaction” means the disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the transaction or arrangement lacks economic substance or a valid California business purpose. The penalty may also be assessed if an entity is disregarded because it lacks economic substance.
For purposes of this provision, the calculation of an “understatement” is made in the same manner as in the separate provision relating to new accuracy-related penalties for listed and reportable avoidance transactions. Thus, the amount of the understatement under this provision would be determined as the sum of:

> (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return), and
>
> (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

Except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the taxpayer is first contacted regarding potentially abusive transaction.

The penalty cannot be compromised for purposes of a settlement without approval of the Chief Counsel of the Franchise Tax Board.

Any understatement to which a penalty is imposed under this provision will not be subject to the ARP. However, an understatement under this provision would be taken into account for purposes of determining whether any understatement is a substantial understatement as defined ARP provisions. The penalty imposed under this provision will not apply to any portion of an understatement to which a fraud penalty is applied.

EFFECTIVE DATE

This provision applies to determinations (regarding economic substance) made after January 1, 2004. Thus, the penalty would apply to earlier taxable years when an economic substance determination was made after January 1, 2004.

4. MODIFICATIONS TO THE SUBSTANTIAL UNDERSTATEMENT PENALTY

FEDERAL LAW

Definition of substantial understatement

An accuracy-related penalty equal to 20% applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10% of the correct tax or $5,000 ($10,000 in the case of most corporations).

Reduction of understatement for certain positions

For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

The Secretary of the Treasury is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.

CALIFORNIA LAW

California law fully conforms to the ARP.

THIS BILL

Definition of substantial understatement

This bill modifies the definition of "substantial" for corporate taxpayers. A corporate taxpayer would have a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10% of the tax required to be shown on the return for the taxable year (or, if greater, $5,000), or (2) $5 million.

Reduction of understatement for certain positions

This bill would elevate the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. This bill also authorizes (but does not require) the Franchise Tax Board to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers). The list shall be published in Franchise Tax Board Notices or other published positions. In addition, "listed transactions" notices shall be published on the Franchise Tax Board's website.

EFFECTIVE DATE

This provision applies to penalties assessed after January 1, 2004. Thus, the penalty would apply to earlier taxable years when the assessment was made after January 1, 2004.

5. TAX SHELTER EXCEPTION TO CONFIDENTIALITY PRIVILEGES RELATING TO TAXPAYER COMMUNICATIONS

FEDERAL LAW

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The IRC provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

CALIFORNIA LAW

California law conforms to federal law as it relates to confidentiality of communication between a taxpayer and a federally authorized tax practitioner. However, California's provision expires on January 1, 2005.

THIS BILL

This bill modifies the exception relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision contained in the Revenue & Taxation Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

6. MODIFICATION TO THE REGISTRATION OF TAX SHELTER AND PENALTY FOR FAILURE TO REGISTER REQUIREMENT.

FEDERAL LAW

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter not later than the day on which the shelter is first offered for sale. A "tax shelter" means any investment with respect to which the tax shelter ratio for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one. The tax shelter ratio is basically the amount of the income tax deductions and 350% of the credits offered by the shelter bears to the taxpayer's investment. Additionally, the shelter must be: (1) required to be registered under federal or state securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state securities agency, or (3) a substantial investment (greater than $250,000 and have at least five investors).

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.

A transaction has a “significant purpose of avoiding or evading income tax” if the transaction: (1) is the same as or substantially similar to a “listed transaction” or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer. Certain exceptions are provided with respect to the second category of transactions.

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The relevant regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding.

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of 1% of the aggregate amount invested in the shelter or $500. However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50% of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75% of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

CALIFORNIA LAW

California law conforms to the federal tax shelter registration requirements with the modification that the tax shelter be organized in California. California law conforms to the federal penalty for failure to timely register a tax shelter with the modification.

Additionally, California law requires a tax shelter promoter, within 60 days of the Franchise Tax Board's request, to file a complete return. The return must contain the following information:

(1) Name of the investment.
(2) Description of the business activities of the investment.
(3) Form of investment, such as limited partnership, limited liability company, investment plan, or arrangement.
(4) A list of investors showing full name, address, social security number, and the amount invested by each investor in the investment during the reporting period.
(5) The total amount invested by all investors during the reporting period in the investment.
(6) Any other related information that the Franchise Tax Board may request.

The return must be verified by a written declaration that it is made under penalty of perjury. The promoter must furnish to each investor a written statement showing all of the following: (1) the name, address, and telephone number of the person making the return, and (2) the aggregate amount of investments of each investor.

The penalty for the promoter's failure to file the return within 60 days of request is $1,000 per investor required to be included on the return, or, if the Franchise Tax Board cannot determine the number of investors, $100,000.

THIS BILL

Registration of tax shelters by organizers

This bill supplements the present law rules with respect to registration of tax shelters. Modifications include California requiring additional information if the FTB publishes the additional request in a public notice prior to the start of the tax shelter. The bill also provides a clear set of triggers for registration of tax shelters. The triggers are:

(1) Organized in this state.
(2) Doing business in this state.
(3) Deriving income from sources in this state.
(4) At least one of its investors is a California taxpayer.

For transactions into after February 28, 2000 (regardless whether the transaction is defined as a tax shelter above), that becomes a listed transaction at any time must be registered by the later of:

1. 60 days after entering the transaction,
2. 60 days after the transaction becomes a listed transaction, or
3. April 30, 2004.

The bill specifies that transactions that become California only listed transactions are not required to register if the transaction was entered into before September 2, 2003.

Penalty for failing to furnish information regarding reportable transactions

The bill imposes a penalty of $15,000 on any organizer who fails to register a shelter or, or who files a false or incomplete registration. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $100,000, or (2) 50% of the gross income derived from the activity. Intentional disregard by a organizer of the requirement to register increases the penalty to 75% of the gross income.

The penalty can be rescinded by the Chief Counsel of the Franchise Tax Board, but only in exceptional circumstances. All or part of the penalty may be rescinded but only if: (1) the transaction is not a listed transaction, (2) the organizer on whom the penalty is imposed has a history of complying with the state income tax laws, (3) it is shown that the violation is due to an unintentional mistake of fact, (4) imposing the penalty would be against equity and good conscience, and (5) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The organizer has no right to appeal a refusal to rescind a penalty.

EFFECTIVE DATE

This provision is effective January 1, 2004, and applies February 28, 2000. For the period February 28, 2000, through December 31, 2003, the registration cannot be due any sooner than April 30, 2004.

7. INVESTOR LISTS AND MODIFICATION OF PENALTY FOR FAILURE TO MAINTAIN INVESTOR LISTS

FEDERAL LAW

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions). Temporary regulations, applicable to transactions entered into after January 1, 2003, under section 6112 contain elaborate rules regarding the list maintenance requirements.

Subsequent to the issuance of the new regulations, the IRS announced that, in order to provide necessary clarification of the list maintenance regulations, the effective date will be changed to the date that revised regulations under section 6112 are filed. The delayed effective date, however, will not apply to listed transactions or transactions that are section 6111 shelters (as defined in Treas. Reg. sec. 301.6112-1T(b)(1)). (Notice 2003-11, 2003-6 I.R.B. 1 (January 17, 2003).)

The temporary regulations, issued in October 2002, provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction. A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the new temporary regulations under section 6011), or (3) any transaction that a potential material advisor knows or has reason to know, at the time the transaction is entered into, is a reportable transaction (as defined under the new temporary regulations under section 6011).

The temporary regulations define an organizer or a seller of an interest with respect to a potentially abusive tax shelter if that person is a “material advisor.” A material advisor is defined as any person who (directly or indirectly) receives, or is expected to receive, a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) $50,000 for any other transaction that is a potentially abusive tax shelter.

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalties for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

<u>CALIFORNIA LAW</u>

California law does not specifically conform to the federal provisions related to promoter returns and lists. California law requires a tax shelter promoter, within 60 days of the Franchise Tax Board’s request, to file a complete return as outlined above under the registration of tax shelters by organizers provision.

<u>THIS BILL</u>

Investor lists

This bill would conform to the federal provision requiring organizers and material advisers to maintain and provide a list with modifications.

For transactions entered into after February 28, 2000, and become listed transactions at any time, an organizer or material advisor is required to automatically submit the list to the FTB no later than the later of:

1. 60 days after entering the transaction,
2. 60 days after the transaction becomes a listed transaction, or
3. April 30, 2004.

The bill specifies that a material advisor is not required to maintain and provide a list for transactions that become California only listed transactions entered into before September 2, 2003.

The penalty for failure to maintain and furnish the required list is a time-sensitive penalty. Thus, an organizer or material advisor who is required to maintain an investor list and who fails to make the list available upon request by the Franchise Tax Board within 20 business days after the request or for listed transactions fails to automatically provide the list will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but fails to provide the list to the FTB. The penalty can only be rescinded by Chief Counsel of the Franchise Tax Board under the same conditions as the penalty under the registration of tax shelters provision.

EFFECTIVE DATE

This provision is effective January 1, 2004, and applies February 28, 2000. For the period February 28, 2000, through December 31, 2003, the list cannot be due any sooner than April 30, 2004.

8. ACTIONS TO ENJOIN CONDUCT WITH RESPECT TO TAX SHELTERS AND REPORTABLE TRANSACTIONS

FEDERAL LAW

Federal law authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.

CALIFORNIA LAW

California law also authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.

THIS BILL

The bill expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions and the keeping of lists of investors by material advisors. Thus, under the bill, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Franchise Tax Board, a list of investors with respect to each reportable transaction.

9. UNDERSTATEMENT OF TAXPAYER'S LIABILITY BY INCOME TAX RETURN PREPARER

FEDERAL LAW

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of $250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of $1,000.

CALIFORNIA LAW

California law conforms to federal law as it relates to the tax preparer penalty with minor modifications to the collection and refund of the penalty.

THIS BILL

This bill alters the standards of conduct that must be met to avoid imposition of the first penalty. The bill replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The bill also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, this bill increases the amount of the penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from $250 to $1,000. The penalty relating to willful or reckless conduct is increased from $1,000 to $5,000.

10. FRIVOLOUS TAX RETURNS AND SUBMISSIONS

FEDERAL LAW

Federal law provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the Internal Revenue Service. The law also permits the Tax Court[6] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless.

CALIFORNIA LAW

California law conforms to the frivolous return penalty as it relates to filing a return. California law contains a comparable provision relating to the Tax Court imposing a penalty but the amount of the penalty is limited to $5,000.

THIS BILL

This bill modifies the frivolous return penalty by increasing the amount of the penalty to a maximum of $5,000 and by applying it to all taxpayers.

This bill also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the bill permits the Franchise Tax Board to dismiss such requests. Second, the bill permits the Franchise Tax Board to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request within 30 days after being given an opportunity to do so.

This bill would require the Franchise Tax Board to publish a list of positions, arguments, requests, and submissions determined to be frivolous for purposes of these provisions.

The penalty can be only rescinded by the Chief Counsel of the Franchise Tax Board if: (1) imposing the penalty would be against equity and good conscience, and (2) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The taxpayer cannot appeal a refusal to rescind a penalty.

[6] Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

11. PENALTIES ON PROMOTERS OF TAX SHELTERS

FEDERAL LAW

Federal law imposes a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualified false or fraudulent statement or a gross valuation overstatement.

A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A “gross valuation overstatement” means any statement as to the value of any property or services if the stated value exceeds 200% of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100% of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

CALIFORNIA LAW

California law conforms to the federal “abusive tax shelter promoter penalty” with no modifications.

THIS BILL

This bill modifies the penalty amount to equal 50% of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

EFFECTIVE DATE

This provision applies to penalties assessed after January 1, 2004.

12. EXTEND STATUTE OF LIMITATIONS FOR ABUSIVE TAX SHELTER TRANSACTIONS

Federal law provides, in general, that taxes be assessed within three years after the date a return is filed (this is the general “statue of limitations” (SOL) for deficiencies). For this purpose, a return that is filed before the original required due date is considered to be filed on the original required due date. If there has been a substantial omission of items of gross income that total more than 25% of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years. If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.

CALIFORNIA LAW

California law follows federal law with exceptions. California law provides for a four-year general SOL. Deficiencies based on federal audit reports can be mailed up to two years after the taxpayer or the Internal Revenue Service (IRS) reports the federal changes to the FTB, if the changes are reported within six months of the final federal determination. If a taxpayer or the IRS notifies the FTB more than six months after the final federal determination, the FTB may mail a deficiency resulting from that adjustment within four years of the date the IRS or the taxpayer notified the FTB of the change. If the taxpayer fails to notify the FTB of the final federal determination, a deficiency reflecting the changes made by the federal determination may be mailed at any time.

THIS BILL

This bill would extend the SOL from four years to eight years for taxpayers who invest in an abusive tax avoidance transaction.

EFFECTIVE DATE

This provision would apply to any return filed on or after January 1, 2000.

13. EXPANSION OF THE FRANCHISE TAX BOARD'S AUTHORITY TO ISSUE SUBPOENAS

FEDERAL LAW

Federal law permits designated individuals of the Internal Revenue Service, in the course of administering federal tax law, to sign and issue summons to any person (meaning any type of entity) or for any purpose. The summons may be issued for records or for persons to appear. Generally, a summons is equivalent to a subpoena.

CALIFORNIA LAW

California law provides that the Franchise Tax Board may issue a subpoena to any person. The subpoena must be necessary in order for the Franchise Tax Board to carry out its duty of administering the franchise or income tax laws. The subpoena may be issued for records or for persons to appear. A member of the Franchise Tax Board must sign the subpoena. The procedure for enforcing the subpoena is dictated by the Government Code, which most other state agencies also use for enforcement.

THIS BILL

For persons involved in a potentially abusive tax shelter, this bill would expand the authority to sign a subpoena of the Franchise Tax Board to include the Executive Officer of the Franchise Tax Board or any designee.

14. MODIFICATION OF THE SUSPENSION OF THE ACCRUAL OF INTEREST PROVISION

FEDERAL LAW

With certain exceptions, federal law provides that the accrual and imposition of interest or penalties on assessments be suspended if before the end of an 18-month period the Internal Revenue Service fails to notify the taxpayer of the assessment. The provision only applies to individuals and to timely filed returns. The suspension period starts 18 months after the original due date of the return (without regard to extensions) or if later the date the return was filed and ends 21 days after the Internal Revenue Service mails a notice to the taxpayer. The notice must contain the taxpayer's liability and the basis for the liability.

The above provision was added to the Internal Revenue Code in 1998. As added in 1998, the provision provides that for purposes of the notification period, a one-year period replaces the 18-month period for taxable years beginning on or after January 1, 2004.

CALIFORNIA LAW

California law conforms to federal as it relates to the suspension of interest for failure to issue a notice to the taxpayer with modifications. California's suspension period ends 15 days after the notice is mailed. Also, for purposes of the notification period, the 18-month period is not replaced with a one-year period. Finally, special rules apply to assessment notices based on a final federal determination (a federal audit).

THIS BILL

For taxpayers involved in a potentially abusive tax shelter, this bill would provide that the suspension of interest provision discussed above does not apply to taxpayers with taxable income greater than $200,000.

EFFECTIVE DATE

The inapplicability of the suspension of interest provision for taxpayers with taxable income greater than $200,000 would apply to notices mailed after January 1, 2004.

15. INCREASE IN INTEREST RATE AND INTEREST BASED PENALTY FOR REPORTABLE TRANSACTIONS

FEDERAL/STATE LAW

Under federal and state law interest is charged on all underpayments of tax. As in the financial industry, the interest charged is not a penalty, it is merely a charge for the use of the money. Under California law the interest rate is adjusted semiannually. Presently, the state interest rate is 5%.

The Internal Revenue Service or the Franchise Tax Board may abate interest, if the taxpayer establishes that a delay was caused by a ministerial or managerial act of the tax agency.

THIS BILL

For taxpayers contacted by the Franchise Tax Board, any underpayment of tax due to a potentially abusive tax shelter, as defined, a penalty equal to 100% of the accrued interest on the underpayment will apply. A potentially abusive tax shelter is defined as any transaction or scheme required to be registered under current federal law and is a reportable transaction under present federal law or state law as purposed under this bill. The penalty applies to notices mailed after the effective date of this bill and is in addition to any other penalty that may be assessed.

For taxpayers not contacted by the Franchise Tax Board or the Internal Revenue Service, this bill increases the prescribe interest rate by 50% for reportable transactions as defined in this bill. The higher interest rate applies to any amended return filed after April 15, 2004.

16. VOLUNTARY COMPLIANCE INITIATIVE

FEDERAL/STATE LAW

Federal offshore voluntary compliance initiative

The federal government's "offshore voluntary compliance initiative" application period ended April 15, 2003. After applying by April 15, 2003, the taxpayer must cooperate with the IRS and pay all tax, interest, and the accuracy related penalty by October 15, 2003. The abusive offshore credit card tax shelter scheme involves taxpayers depositing unreported income in foreign banks and using credit or debit cards drawn on the foreign bank to spend the money. It is estimated that as many as 1 million Americans have foreign credit or debit cards (not all will be involved in an abusive tax shelter scheme).

California is participating in the federal initiative. Taxpayers accepted in the federal program may apply with the FTB. The taxpayer must also pay all tax, interest, and the accuracy related penalty by October 15, 2003, to qualify.

Accuracy related penalty in general

Federal and state law provides the accuracy related penalty will be not assessed when a taxpayer files a "qualified amended return." A qualified amended return is a return that is filed after the filing of the original return and prior to the taxpayer, a tax shelter promoter, or a pass-through entity is either contacted by the Internal Revenue Service or the Franchise Tax Board regarding an examination.

THIS BILL

This bill would establish a one-time voluntary compliance initiative (VCI) allowing taxpayers that utilized abusive tax schemes to underreport their tax liabilities to amend their tax returns and come clean with the state. The offer would be extended to any type of abusive tax scheme, except those schemes using offshore accounts to shelter income. Taxpayers who are subject to a criminal investigation or have a criminal compliant filed against them would not be eligible to participate in the VCI. The VCI would be offered to taxpayers between the period January 1, 2004, and April 15, 2004, for taxable years beginning before January 1, 2003. The taxpayer must file an amended return reporting all income and loss without regard to the abusive tax shelter scheme or transaction(s), and pay the tax and the interest. The taxpayer may request to pay the tax and interest under an installment agreement. The taxpayer has two elective options to participate in the VCI:

Option A – Voluntary compliance without appeal rights, this option includes waiver of all penalties, including all existing and the new or increased penalties under this bill**.** The statute would provide that if the taxpayer's amended return is accepted by the department, the issue would be considered closed. A closing agreement may be used. The taxpayer cannot file a claim for refund and the department cannot issue any deficiency assessment.

Option B - Voluntary compliance with appeal rights, this option includes waiver of all existing and new or increased penalties, except the accuracy related penalty (as in effect prior to the passage of this bill). The statute would provide that if the taxpayer's amended return is accepted by the department, the taxpayer may file a claim for refund for the tax and interest paid under the VCI. The six-month deemed denial of claims for refund would be suspended until the Franchise Tax Board takes action on the claim for refund or until the earlier of 180 days after a final federal determination of the transaction or four years after the claim was filed. If the taxpayer's claim prevails, a refund with interest will be issued. If the transaction is determined to be an abusive tax scheme, the taxpayer may also be liable for the accuracy related penalty under present law.

The Franchise Tax Board is required to issue forms and instructions and take any other action necessary to implement the tax shelter provisions of Chapter 9.5 of Part 10.2 of the Revenue & Taxation Code, as added by this bill. The Franchise Tax Board would be required to publicize the VCI to the highest degree possible. It is anticipated that the Franchise Tax Board will mail letters to all taxpayers identified as being involved in a potentially abusive tax shelter transaction or scheme. The letter will outline all provisions of this bill and encourage those taxpayers involved in an abusive transaction to take advantage of either Option A or B to avoid penalties. The bill provides that the letter constitutes "contact" for purposes of determining if an amended return qualifies for certain penalty relief.